

U.S.-Japan Comprehensive Economic Partnership Agreement: Cementing a Geostrategic Economic Relationship

Robert C. Fauver and Devin T. Stewart

Since the 1980s, the idea of a U.S.-Japan free trade agreement has been proposed every two years or so, only to be defeated by protectionists and pessimists. Now, however, a new set of geopolitical as well as economic circumstances make such an agreement not only desirable but necessary if the United States and Japan wish to advance their common stake in the future of East Asia. This paper discusses the historical background and the new circumstances that make a free trade agreement increasingly urgent, what such an agreement might look like, including its economic and strategic benefits, and how actors in both countries might respond.

The idea of formally integrating the world's two largest economies, Japan and the United States, has been floated intermittently since the 1980s. Michael Mansfield, the longest-serving U.S. Ambassador to Japan (1977–1989), was a notable and longtime supporter of the idea.¹ In the late 1980s and early 1990s, a series of bilateral U.S.-Japan negotiations called the Structural Impediments Initiative (SII) focused on barriers inside the Japanese and U.S. economies that impeded the international flow of goods and services. These negotiations identified a wide set of domestic policy

Robert Fauver co-chaired negotiations with Japan on structural reforms for the first Bush administration and was the U.S. representative to the 1993 Tokyo Economic Summit for President Bill Clinton. Devin Stewart is a research associate at the Research Institute of Economy, Trade and Industry in Tokyo and a graduate of Johns Hopkins School of Advanced International Studies.

barriers that hindered the creation and operation of efficient markets in Japan by shielding Japanese firms from competition. Similar discussions took place during the Clinton administration under the 1993 United States-Japan Framework for a New Economic Partnership, known as the Framework Agreement, and continue today under the current Bush administration. However, none of the recommendations issued under these ongoing talks are legally binding, and none have significantly altered policy formulation in either country in the face of opposition from interest groups that benefit from trade protection.

To date, the rationale for a comprehensive trade agreement between the United States and Japan has been primarily economic; increased economic integration would generate stronger growth, more jobs, and more wealth for the people in both countries. While this fundamental economic argument still applies, it is clearly not enough to push the idea beyond the conceptual phase. But a new set of political circumstances and emerging geostrategic issues makes a U.S.-Japan free trade agreement both more feasible and more necessary now than ever before.

On the Japanese side, the desperate economic situation calls for strong responsive measures. In order to successfully steer the Japanese economy toward sustained recovery, Prime Minister Junichiro Koizumi needs a policy roadmap that succeeds in boosting both business and consumer confidence. In addition, Japan, after decades of focusing exclusively on multilateralism as the cornerstone of its trade policy approach, has started forming bilateral economic partnerships in Asia, reflecting a philosophical change in the country's economic policy. With a completed arrangement with Singapore and the beginning of negotiations with South Korea, there is considerable momentum for economic liberalization. These agreements show that Japan can muster the domestic support for change; they also may provide the political momentum for subsequent and more significant trade agreements. On the U.S. side, the President now has trade promotion authority for the first time since 1994, and foreign and security policy advisors in the Bush administration view Japan as the keystone to U.S. policy toward Asia. Deputy Secretary of Defense Paul Wolfowitz has echoed Ambassador Mansfield's assessment that the U.S.-Japan relationship is the most important in the world "bar none."²² National Security Advisor Condoleezza Rice, U.S. Trade Representative Robert Zoellick, and Deputy Secretary of State Richard Armitage have all indicated that they view Japan as the

United State's best ally in Asia,³ and U.S.-Japanese bilateral ties have not been calmer in recent history.

Geostrategic concerns argue even more forcefully in favor of increased U.S.-Japanese integration. Tighter bilateral ties must become the top priority for the United States and Japan in order to prepare for

China's rise as an economic and military power and the possible eventual reunification of the Koreas. The incentive for the two countries to form a stron-

Tighter bilateral ties must become the top priority for the United States and Japan in order to prepare for China's rise as an economic and military power and the possible eventual reunification of the Koreas.

ger bond has gone from one of wealth creation to one of security—from David Ricardo to Henry Kissinger.

This paper will consider a comprehensive U.S.-Japan economic partnership as a solution to some of the most pressing economic and geostrategic issues facing both countries as well as the feasibility of achieving such a partnership.

Jumpstarting Reform

The greatest challenge currently facing Japan is the continued poor health of its economy. It is abundantly clear that the Japanese economy has been in the doldrums for a decade. The economy has dipped in and out of recession for years, wages are falling, and unemployment is at a record 5.5 percent (or 3.6 million people) with no improvement in sight. Japan has experienced falling prices since 1999, when its inflation rate slipped below zero to negative 0.3 percent. Though real GDP growth reached an unexpected high of 0.5 percent during the last quarter of 2002 (an annualized rate of 2 percent), Japan recorded zero growth during the first quarter of 2003, due to weak domestic and foreign demand. Recessionary forces pervade the economy. Investment spending by corporations is non-existent. Consumers are saving instead of spending. Private saving is fleeing domestic markets for foreign asset markets. Estimates of non-performing loans in the banking system continue to increase. Bankruptcies are on the rise in small and medium sized

firms while bank lending props up unprofitable large companies under the *keiretsu* system. Near-zero interest rates and government subsidies make it cheaper for banks to keep these “zombie” companies alive than to let them die and write off the loans.⁴ In fact, the sorry state of Japanese bank management reportedly led to an investigation by the International Monetary Fund at the end of last year.⁵

Annual supplemental fiscal stimulus packages focusing on public infrastructure spending have not stimulated sustained economic growth. On the contrary, these expenditures have tended to postpone much needed structural adjustments in the overgrown construction sector. Author and lecturer Alex Kerr estimates that in 2000 Japan was spending 9 percent of its GDP on construction and that 60 percent of its coastline has been paved.⁶ Near-zero nominal interest rates since 1999 have been no more successful in stimulating either consumption or investment. Instead, they have made it easier for banks to continue high-risk lending to long-term corporate clients and have further contributed to consumer tendencies to increase savings by lowering the return on investment assets.

A decade of low growth and negative financial news has left consumer and business confidence in tatters. Consumers, looking ahead to a bleak future, are loath to spend. Business is similarly wary of investing in such a weak economy. Capital spending has been mostly negative for nearly ten years and declined further in 2002; capital spending in all industries fell by 13 percent in the first half of fiscal year 2002 and by 3.2 percent in the second half.⁷ The press continues to focus on negative aspects of the economic situation, reinforcing low expectations. Even in response to the seemingly good news of positive economic growth at the end of 2002, newspaper headlines referred to “mounting gloom”⁸ about and “somber assessments”⁹ of the Japanese economy.

Consumer and business confidence must fundamentally change if Japan is to emerge from its economic malaise. Clearly the domestic economy needs a shock to rekindle confidence on the part of consumers and business (and we would argue the government itself), and to kickstart the economy. The question is what sort of shock it will take. Most importantly, will it be a positive or a negative shock? Will it come from the failure of several large corporations? Or from a voter-led rejection of the ruling Liberal Democratic Party (LDP) and its approach to economic reforms? Will it come from inside or outside Japan?

Historically, Japanese policymakers have responded slowly to the need for change. They have typically moved forward either in the midst of a serious crisis, or under significant pressure from the United States. Historical examples include the U.S. effort (1945 to 1952) to install democracy in Japan, and Commodore Matthew Perry's "black ships," which opened Japan to trade after 250 years of isolation in 1854. Significant political constraints prevent authorities from undertaking reforms needed to restructure the economy. The LDP has particularly strong connections to the agricultural and construction sectors, two of the sectors most in need of fundamental restructuring. This financial connection between the ruling party and "old" sectors of the economy prevents policymakers from pushing an active domestic reform agenda. On a more fundamental level, the bleak dilemma facing Japan's policymakers is that the country's economic problems require recessionary (restructuring and curtailing of pork-barrel projects) and deflationary (the disposal of non-performing loans and assets) policies, which will mean even more short-term economic pain before any potential improvement materializes. For all of these reasons, the necessary reforms to Japan's economy are unlikely to come from within.

The United States has an opportunity to provide the positive shock necessary to overcome government inertia and negative economic expectations and put Japan on the road to recovery. A new round of economic and financial negotiations toward a comprehensive economic partnership would exert external pressure for change. If a comprehensive agreement were reached, the resulting economic liberalization would both stimulate the economy and boost productivity. Trade liberalization could also

The United States has an opportunity to provide the positive shock necessary to overcome government inertia and negative economic expectations and put Japan on the road to recovery.

help combat deflation in the long run if higher incomes, resulting from labor moving to more productive sectors, boost the price of goods and services. However, such positive effects will only result from a legally binding trade agreement; only a binding and

enforceable agreement will have the credibility to alter negative consumer and business confidence and economic expectations.

A computer simulation of a U.S.-Japan free trade agreement (FTA) conducted at the Tokyo-based Research Institute of Economy, Trade and Industry in March 2003 models the economic benefits from an FTA.¹⁰ The simulation, which analyzed the effects of bilateral tariff elimination only, showed that export volumes, capital stock, and real GDP would increase in both countries. Greater productivity would raise incomes and prices, thereby increasing the terms of trade. The positive economic effects are comparable to the U.S.-Canada FTA, signed in 1988, which has been associated with long-run labor productivity gains of 17 percent, mostly due to favorable plant turnover and rising technical efficiency, according to economist Daniel Trefler.¹¹

Geopolitical Incentives

Geopolitics as well as economics support the idea of economic integration between the United States and Japan. The Asian geopolitical landscape is changing as China drives to become the regional superpower. The Pentagon acknowledged in a July 2002 report to Congress that China is seeking to “diminish U.S. regional influence.”¹² The report goes on to note that China views the United States as a “significant long-term challenge.” China continues to expand its military spending and posture. The country has aimed 350 Dong Feng-11 ballistic missiles at Taiwan, purchased Kilo-class submarines and other weapons from Russia at an amount totaling approximately \$1 billion a year, and may be spending \$65 billion a year on its military—more than three times the official figure. Another report, by the U.S.-China Security Review Commission, a congressional commission, supports the Defense Department’s basic premise and suggests that the United States proceed with “far more prudence” in formulating its policy toward China.¹³ China’s influence in the region is already conspicuous in Japan. Policymakers at the Ministries of Finance, Trade, and Foreign Affairs routinely consider Chinese motives before formulating policy, something that rarely happened just three years ago.¹⁴

These reports are right to recommend that the United States engage and monitor China, yet they miss the bigger strategic picture. Japan and the United States can build on common interests and balance China’s economic and military ascent. China does have the largest army in the world with 2.8 million soldiers, and

the country's rapid economic growth means military spending will likely continue to grow, but combined U.S. and Japanese military expenditures of over \$400 billion still dwarf China's spending of \$60 billion.¹⁵

Potential Korean reunification or federation would also challenge the current security landscape in Northeast Asia. While China worries that reunification would eliminate a buffer state and result in large-scale immigration, there is the strong possibility that a reunified Korea might tilt toward China and away from the United States. Given the rise in anti-American sentiment in South Korea, foreign policy expert Dan Bob at the Council on Foreign Relations argues that the United States needs to do a better job to prevent such a scenario.¹⁶

These shifts in the balance of power in Asia present the United States and Japan with several options. One, Japan could accept China as the new regional power. In this scenario, Japan would decrease ties with the United States and bandwagon with China. Two, Japan could do nothing, which would probably result in a slow drift into irrelevance. Tokyo policy analysts say this option is likely, *ceteris paribus*. Three, Japan and the United States could jointly balance Chinese power, in effect forcing it toward the U.S.-Japan relationship and its values out of strategic necessity. This third option is the most attractive because it maintains a shared and active role for both countries in shaping Asia's political and strategic landscape.

In the security arena, a formal U.S.-Japan economic agreement would represent a carrot—the potential for membership—with an implied stick for regional challengers like China, balancing their power without provoking an arms race. A U.S.-Japan economic zone would balance China's power in five ways. First, nearly all countries in Asia will be economic competitors to the rising Chinese economy, as most are still highly dependent on low-cost labor production schemes. Countries that join the proposed U.S.-Japan economic zone will share its economic benefits, receive foreign investment flows and technology, and tap into supplying a huge consumer market. Second, sustainable military spending and influence is based on adequate public funding, and therefore on economic growth. The positive shock effects of an economic integration agreement would thus support Japan's defense posture in the region by giving a new lease to the growth prospects of the Japanese economy. Third, Japan and the United States can cooperatively bring pressure to bear over intellectual property rights in

the World Trade Organization (WTO) or regional forums, as the Cairns Group does in agriculture, limiting Chinese-led piracy that eats away at the market share and profits of U.S. and Japanese corporations. Fourth, similar to U.S. FTAs with Jordan and Israel in the Middle East, formal economic integration will signal to regional challengers and domestic polities that U.S. and Japanese interests are contiguous, and that the U.S. presence in Asia is still strong.

Fifth, an economic integration agreement would allow Japan and the United States to dictate the terms of a regional trade bloc, something that China is pursuing in the form of ASEAN+3, or the member countries of the Association of Southeast Asian Nations plus China, Korea, and Japan. Kenichi Kawasaki, an econometrician at the Research Institute of Economy, Trade and Industry, argues that a trade bloc in East Asia that included Japan would create more gains from trade than would one without, as the economies of China and ASEAN are less complementary with each other than they are with Japan.¹⁷

The bottom line is, who will shape Asia's future trade map, China or Japan? And will the United States be included? The answer will depend on which country can create the largest trade bloc first and which country can create a market that provides significant trade expansion opportunities for ASEAN. The race is already on. China and ASEAN have set June 30, 2004 as the deadline for an agreement to phase out tariffs by 2010 for the six original members of ASEAN and 2015 for the poorer members.¹⁸ But formal U.S.-Japan economic integration would create the biggest single market with the highest per capita GNP in the world and enormous trade opportunities. A U.S.-Japan economic zone would represent a \$15 trillion economy, meaning it would certainly become the dominant force in the region. Richard Baldwin of the University of Geneva theorizes that when two trading blocs exist side by side, the smaller one collapses into the larger. This "domino theory" suggests that China would be compelled to apply for membership in a U.S.-Japan trade bloc.¹⁹ Such a trade bloc would also help the international system by preventing a division into three regional blocs in Asia, the Americas, and Europe—a concern raised by C. Fred Bergsten of the Institute for International Economics if ASEAN+3 or an East Asian FTA moves ahead.²⁰

A U.S.-Japan economic zone, besides balancing China, could also foster U.S. and Japanese political goals, such as the spread of democracy, by requiring certain standards of countries that wish

to join—similar to the EU’s criteria for new member state standards of human rights and rule of law. For example, most countries have environmental and labor laws that they do not enforce; all countries wishing to join a U.S.-Japan economic zone could be required to enforce their own national laws, as was done in the U.S.-Jordan trade pact and the more recent U.S.-Chile trade pact, bolstering human rights and respect for democracy. This would mean that

A U.S.-Japan economic zone, besides balancing China, could also foster U.S. and Japanese political goals, such as the spread of democracy, by requiring certain standards of countries that wish to join—similar to the EU’s criteria for new member state standards of human rights and rule of law.

it would be open to Taiwan, one of the latest to solicit an FTA with Japan.²¹ The zone could eventually include South Korea, Thailand, and Indonesia, and other APEC members to create a web of economically integrated democratic states bordering the Pacific.

Blueprint for a U.S.-Japan Comprehensive Economic Partnership Agreement

In order for a U.S.-Japan Comprehensive Economic Partnership Agreement (CEPA) to have the dynamic effects that are called for in today’s economic environment, the agreement must strive for the broadest possible integration of the two countries’ economic and trade regimes. Over the past several decades, direct barriers to trade between the United States and Japan have been slowly reduced. Tariffs and non-tariff barriers (NTBs) have been eliminated or significantly eased with a few notable exceptions. Yet these incremental moves toward liberalization have failed to improve the economic situation in Japan. It is therefore evident that the removal of the remaining trade restrictions (tariff and NTBs) would not result in a significant restructuring of the Japanese economy.²² Hence the negotiation of a basic U.S.-Japan FTA is not sufficient to reverse the negative business and consumer confidence levels in

Japan, nor to pressure Japanese authorities into significant reform. Only a legally binding agreement focused on a tight integration of the two economies can fundamentally alter the expectations of both consumers and business.

This article proposes that the two countries move beyond an old-fashioned FTA toward a comprehensive economic partnership agreement (CEPA). A CEPA would integrate the economies, competition policies, regulations, and labor markets of the two countries. It would change the bilateral relationship from one defined by trade and capital flows to a single market. While a classic FTA focuses

A U.S.-Japan CEPA would produce a single market for goods and services comprising more than half of the world's GNP, introducing investment incentives and growth forces to lift Japan from its current doldrums.

on trade restrictions at the border, a CEPA would focus on internal policies as well. It would include the factors that determine the shape and competitive-

ness of the domestic market, harmonizing many domestic policies between the two countries. Similar to a common market, it aims for complete integration before starting and does not impose a common external tariff as does a customs union. A U.S.-Japan CEPA would produce a single market for goods and services comprising more than half of the world's GNP, introducing investment incentives and growth forces to lift Japan from its current doldrums.

A CEPA would take as its starting point the model of economic integration expressed in the North American Free Trade Agreement (NAFTA). It would be tailored specifically to fit into the NAFTA framework, providing the eventual basis for economic integration not only with the United States but also with Canada and Mexico. However, as noted above, a NAFTA-like model is necessary but not sufficient to change Japanese expectations. The sufficient condition for providing real momentum for change would come from the new areas to be included in the CEPA that move beyond those already envisioned in the NAFTA documents, discussed below. Since the NAFTA negotiations covered many of the areas to be included in a CEPA, part of the hard groundwork has

already been laid. Of course, new areas would be included, but the conceptual framework has already been established.

The goal of CEPA negotiations would be to fully integrate these two major industrial economies. Full integration necessitates similar policy approaches on many internal economic regulatory issues ranging from accounting standards and rules to the enforcement of anti-monopoly laws. Mutually supportive policies would bolster growth opportunities and the efficient allocation of resources in both countries. Considering the current state of Japan's domestic economy, four areas of harmonization in particular would provide the most important impetus for change in growth expectations and the strongest benefits to the Japanese economy. (Only one of these four—dispute resolution—is covered in NAFTA.) While the major changes would be to the Japanese economy, a stronger Japan would benefit the United States as well.

First, a CEPA would address harmonization of policy, regulations, and practices relating to corporate structure and governance. The most important issues range from the harmonization of tax policies pertaining to mergers and acquisitions, stock options, and venture capital to corporate governance standards that affect the transparency of corporate Japan—stockholder rights, board structure, and auditing and accounting practices. Adoption of U.S. corporate governance standards in Japan would increase stockholder rights and push Japanese firms to focus on profits and performance. Such standards would also increase transparency and strengthen confidence levels. Greater transparency in corporate practices would tend to make price structures in both commodity and labor markets more transparent.

Second, a CEPA would address competition policy, particularly anti-monopoly enforcement in Japan, an unresolved issue in the two countries' bilateral relations. For Japanese businesses, these first two areas of reform would result in increased competitive pressure that would reinforce the recent trend away from the old cartel-like *keiretsu* relationships between businesses and banks that have been such a burden to the Japanese economy. The resulting efficiency gains in Japanese firms would raise profitability. Higher profitability for those firms that adjust to the new environment would generate more tax revenue, thereby ensuring the solvency of the central and local governments.

Third, a CEPA would cover dispute settlement, addressing bilateral trade frictions by building a formal mechanism for dispute resolution. The experience under NAFTA (and the more re-

cent experience with the WTO dispute settlement procedure) suggests that a formal mechanism reduces the pressure for unilateral trade policy legislation or regulation that interferes with the free flow of trade. Without a dispute settlement mechanism, countries tend to impose trade restrictions (quotas and tariffs) unilaterally, which typically leads to retaliation by the other party.

Fourth, a CEPA would establish standards in the important growth area of information technology (IT), which, as the Japanese government has surmised, will help move the economy toward newer business models that are more appropriate to Japan's current factor endowments. Agreements on e-commerce, signature authentication, intellectual property issues, and trade in digital products are all key to securing the success of IT growth. An internationally competitive IT market would enable Japanese firms to be global players in business-to-business and business-to-consumer relations. It would also enhance the attractiveness of regional centers in Japan versus the current excessive focus on Tokyo and its nearby regions. Cheaper IT business costs and the availability of world class IT throughout Japan changes the relative attractiveness of locating businesses in major metropolitan centers such as Tokyo and increases the attractiveness of other parts of Japan that may provide a higher quality of life for employees. Policies to promote IT development and decentralization have a great deal of support within reform-minded ministries.

The most important benefit of a CEPA would be to make the Japanese domestic market more competitive. Increased Japanese competition would result in cheaper products of higher quality for consumers and businesses; higher living standards, real incomes, and GDP; and a stronger international position for Japanese firms.

Firms must be allowed to undertake similar business activities in both countries and "export" successful business models without undue regulatory barriers. For example, U.S. firms could bring dynamic leadership to Japan's management and integrated IT systems. The U.S. focus on profits could alter Japanese approaches to business performance, for example, in terms of labor-management relations. On the other side, U.S. firms would learn from Japanese success in "marketizing" R&D and in implementing fast change from design to production. Increased international trade flows should lead to greater exchange of ideas and methods between the two countries.

Feasibility and Obstacles

There will be resistance to a U.S.-Japan CEPA. As with almost any trade liberalization agreement, though the overall gains would outweigh the losses, certain sectors would be clear losers. In Japan, the losers would be concentrated in the agricultural sector. Indeed, Japan has the most protected farm sector among countries in the Organisation for Cooperation and Development (OECD) with a tariff equivalent of 631 percent on rice and 538 percent on wheat,²³ four times higher than the OECD average. The losers in the United States would be automobiles and steel producers. The U.S. steel lobby is small but powerful, and steel has been a chronic source of conflict in U.S.-Japan trade relations for years. In March 2002, President Bush yielded to Big Steel's pressure, placing tariffs of up to 30 percent on steel from a host of exporters, including Japan.

These groups may not, however, be insurmountable obstacles. The President's early concession to the U.S. steel industry may have given him leeway to pursue a more ambitious free trade agenda in the future. Also, not all of the steel industry is protectionist; many second-tier producers substitute imported slab for their own in order to take advantage of the lower costs of cheap imports. Moreover, since steel is ubiquitous in many economic processes, nearly all other sectors would benefit from cheap Japanese steel, especially the automobile sector. Though U.S. automakers would face increased competition from Japanese automakers, they would benefit from cheaper steel, which might help limit their opposition to a CEPA. On the Japanese side, the economy's dire straits might make the government desperate enough to pursue major changes. In addition, legally binding agreements have a stronger history of success in Japan than non-binding ones, as illustrated by earlier binding agreements on civil aviation, semiconductors, and construction.

In order to overcome protectionist forces, both countries must identify free trade interests and unite them. Both countries should also find an adept spokesman to make the case for a CEPA. In 1993, just eight days before crucial votes in Congress, Vice President Al Gore debated Ross Perot (the unofficial

In order to overcome protectionist forces, both countries must identify free trade interests and unite them.

voice of those against free trade) on the merits of NAFTA. Remarkably, the vice president shifted public opinion to support the trade agreement.

To get an idea of the kind of resistance such an agreement might engender and how Japan and the United States can prepare, the U.S.-Canada FTA provides important experience to draw on. In Canada, the prospect of an agreement of such scope with the United States was very controversial, particularly among agriculture, trucker, and labor groups. The labor union assembly Canadian Labour Congress, concerned about job losses and the impact on social programs, planned a \$1.5 million campaign against the agreement, according to a Canadian trade official.²⁴ The Canadian government responded with a preemptive education program for the public on the benefits of free trade. In 1982, before negotiations even began, the government established the Royal Commission on the Economic Union and Development Prospects for Canada, which carried out sixty hearings and commissioned dozens of research projects on Canada's economic potential. The commission laid the intellectual groundwork for the Mulroney government's free trade vision. Indeed, the establishment of this sort of commission in the United States or Japan would help to sell the CEPA idea to the public.

How long will it take to negotiate a CEPA? If it is going to be effective, it must beat the China-ASEAN timetable of 2010. How, then, can the negotiations be pushed along? The experience of past negotiations between the two countries provides some lessons. U.S. negotiators during the Yen-Dollar talks that began in 1983 learned that outside influence could be helpful in securing domestic support for a policy or regulatory change—so long as the authorities had already decided that they wanted to change.²⁵ U.S. negotiators used the talks as a forum to exert pressure on their colleagues to secure the already-desired change. This method of operation continued during the Structural Impediments Initiative (SII) discussions. The 1989–1992 SII talks were most successful in promoting change when the U.S. proposals or ideas for change were coincident with the views of the particular vice minister in charge. In contrast to the situation in the United States, ministries in Japan do not tend to exert pressure on each other in terms of policy reforms. Whereas on the U.S. side, positions on issues relating to different departments were often determined by pressure from within the administration and tradeoffs between departments, in Japan the ministries tend to be the sole determiners of

the outcome on issues under their jurisdiction. So cross-ministry pressure or building tradeoff pressures is unlikely to succeed.

Negotiations may best be pushed along, then, by tailoring the way reforms are presented and discussed to fit existing ideas within the ministries in charge of each particular issue. The good news is that key people in Japan's Ministry of Economy, Trade, and Industry and many people in charge of Japan policy in the Bush administration support the concept of a U.S.-Japan FTA. The next step will be to bring the idea up to the political level, and have the two heads of state discuss the framework and begin building domestic coalitions that can counter protectionist opposition.

Conclusion

A U.S.-Japan CEPA would aim to further the integration of the two economic systems and facilitate the spread of ideas and business perceptions between the two economies, leading to efficiency gains. For Japan and the United States, this formal economic zone would improve the growth prospects of both economies, allow for a wider range of foreign policy choices, and make the free market democratic system more attractive. For the global trading system, such an agreement would expand both markets, providing increased trading opportunity for developing countries. It would also preclude a three-bloc world of Asia, Europe, and the Americas.

It is conventional wisdom, but no less true, that a healthy Japanese economy is synonymous with a strong U.S.-Japan alliance. Neither Japan nor the U.S.-Japan alliance can afford another decade like the last if they are to counter the rise of China as an Asian power and continue to influence both the economic and political development of Asia in directions beneficial to both. The moment to realize a comprehensive U.S.-Japan free trade agreement has finally arrived.

Notes

¹ Masabumi Suzuki, "Toward Constructive International Trade Resolution: Lessons from Recent U.S.-Japan Disputes on Restrictive Practices," Brookings Institution CNAPS Working Paper, 1999, Center for Northeast Asian Policy Studies, Washington, DC, <http://www.brook.edu/fp/cnaps/papers/1999_suzuki.htm> (17 May 2003).

² Remarks delivered at the U.S.-Japan Business Conference, Ritz-Carlton Hotel, Washington, DC, 18 February 2002.

³ Hisahiko Okazaki, "New Opportunities for US-Japan Ties," *Japan Times*, 1 January 2001. The author cites a Rice-Zoellick article in *Foreign Affairs* and the "Armitage Report."

⁴ Ken Belson, “Sick Banking System Resists Therapy,” *New York Times*, 29 October 2002; see also Howard French, “Japan Keeps Wallowing in a State of Denial,” *International Herald Tribune*, 4 March 2003.

⁵ Peter Goodman, “IMF Team Favors Prodding Japan; Economists Think Rules on Bad Loans Need Tightening,” *Washington Post*, 20 December 2002.

⁶ Alex Kerr, *Dogs and Demons: Tales from the Dark Side of Modern Japan* (New York: Hill & Wang, 2002), chapter one.

⁷ Economic and Social Research Institute, Cabinet Office, *Business and Investment Survey of Incorporated Enterprises*, 2002, Tokyo, Japan.

⁸ “Japan leaves economic report unchanged despite mounting gloom,” Agence France Press, 19 February 2003.

⁹ “Bank of Japan Maintains Somber Assessment of Economy,” Dow Jones, 6 March 2003.

¹⁰ Kenichi Kawasaki, “A U.S.-Japan Free Trade Agreement Simulation,” *Miyakodayori* 63, Research Institute of Economy, Trade and Industry, 13 March 2003, Tokyo.

¹¹ Daniel Trefler, “The Long and Short of the Canada-U.S. Free Trade Agreement,” National Bureau of Economic Research, NBER Working Paper No. w8293, May 2001, Cambridge, Massachusetts.

¹² U.S. Department of Defense, “Annual Report on the Military Power of the People’s Republic of China,” Report to Congress, 12 July 2002, Washington, DC.

¹³ U.S.-China Security Review Commission, “The National Security Implications of the Economic Relationship Between the United States and China,” Report to Congress, July 2002.

¹⁴ Personal communication.

¹⁵ Defense Agency, *Boei hakush* (Defense of Japan), 2001; Center for Defense Information, *The Defense Monitor* 30, no. 7 (August 2001): 7, <<http://www.cdi.org/dm/2001/issue7/dm701.pdf>> (22 June 2003).

¹⁶ Personal interview, 27 February 2003.

¹⁷ Personal interview, 12 March 2003.

¹⁸ Alan Wheatley, “Asia Eyes Grand Plan for Regional Free Trade,” Reuters, 10 March 2003.

¹⁹ Richard Baldwin, “Prospects and Problems for East Asian Regionalism: A Comparison with Europe,” talk delivered on 31 January 2003 at the Research Institute of Economy, Trade and Industry, Tokyo. Summary available at <<http://www.rieti.go.jp/en/events/bbl/03013101.html>> (15 July 2003).

²⁰ C. Fred Bergsten, “Brunei: A Turning Point for APEC?” Institute for International Economics, February 2001, Washington, DC.

²¹ “Taiwan wants free trade pact with Japan,” Asia Times Online, 30 November 2002, <<http://www.atimes.com/atimes/China/DK30Ad03.html>> (22 June 2003).

²² An FTA that included agricultural trade might have the required positive shock effects.

²³ Patrick Messerlin, “Plowing Up Subsidies,” *Foreign Policy* 133 (November/December 2002): 30–31, based on data from OECD, *Agricultural Policies in OECD Countries: Monitoring and Evaluation*, 2002, Paris.

²⁴ Personal interview, 12 March 2003.

²⁵ The Yen-Dollar talks took place in the run up to the Plaza Agreement, reached in September 1985. Under that agreement, France, West Germany, the UK, the United States, and Japan agreed on the need to adjust domestic macroeconomic

policies in order to stimulate growth and to realign exchange rates, and indicated that they would intervene in the markets if the dollar continued to be overvalued.